Up in Smoke

By Dan Hassert
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Some call cigarettes a source of pleasure, others a source of poison. In Kentucky - where some 12.8 billion sticks will be sold this year - they're mostly a source of gold.

Gov. Ernie Fletcher says he has a bold plan to increase the clank of that gold by $150 million a year. But his proposal has drawn the ire of Big Tobacco, skepticism from key legislators and alarm from attorneys general from around the nation. Critics say Fletcher could be jeopardizing an existing $100 million a year revenue stream, opening Kentucky up to years of expensive litigation and possibly dooming the 1998 national tobacco settlement - not to mention boosting the cost of a pack of cigarettes by up to 40 cents a pack.

"Why should we be the guinea pig when we stand to lose so much?" said state Rep. Royce Adams, D-Dry Ridge. "We've got to be cautious."

But administration officials say the risk is exaggerated and the gain worth the gamble. "We're subsidizing the budgets of other states," said Stan Cave, Fletcher's chief of staff. "We have a rare opportunity to correct that inequity."

At the heart of the acrimonious debate is the Master Settlement Agreement, the simple name for the "insanely complicated" deal between tobacco companies and 46 states. The agreement enabled companies to head off liability for health costs created by cigarettes in exchange for payments of more than $206 billion over 25 years to state coffers and changes in marketing strategy. But some Kentucky officials say it's unfair because while Kentucky sells 3.4 percent of the nation's cigarettes it gets only 1.76 percent of the MSA pool, or about 50 cents for each $1 contributed by companies who sell cigarettes in the state.

In contrast, New York gets about $3.65 for each $1 from cigarettes sold there.

"That's a great deal - if you live in New York," Fletcher said in his State of the Commonwealth address Jan. 9.

The governor said he had a better way that would keep more money in state. Kentucky should forego MSA payments and instead create a flat per-carton "manufacturer's assessment fee" of about $4, he said, insisting the fee was not a tax.

Cave said everybody would win: Kentucky would come out $150 million a year ahead, both small and large tobacco companies could substitute that fee for existing MSA payments, the national settlement would survive and smokers would pay only 5 cents to 15 cents more a pack (much less than more traditional excise tax increases being discussed). He said the administration is writing a bill and looking for a sponsor, preferably in the House but possibly in the Senate, because resistance in the House is high.

That resistance, legislators say, is because they're dubious of all four claims - that this would be a budget windfall; that it would have minimal impact on competition between tobacco companies, the MSA's future and consumer prices; and that Kentucky got a raw deal.

The MSA "is certainly not something to be trifled with," warned Mark Greenwold, chief counsel for tobacco for the National Association of Attorneys General.

Details of the debate:

The budget: One concern with MSA payments is that they've been decreasing as the number of cigarettes sold nationwide has gone down. In fiscal year 2000, Kentucky received $142.3 million from the MSA. In the fiscal year ending June 30, that figure is expected to drop to $91.3 million, said Greg Harkenrider, the chief state forecasting specialist in the Governor's Office for Policy Research. Next fiscal year it will be even lower at $88.8 million.

In contrast, Cave said, a $4-a-carton assessment would bring in about $250 million directly to the state. Even assuming the state loses its MSA payment and assuming about $100 million would go to the same programs the current money goes (things like early childhood and smoking cessation), Kentucky would have $150 million more. Knowing the proposal's prospect was uncertain, the governor didn't build that money into his budget proposal, Cave said.

But in his budget address Jan. 17, Fletcher said he had definite plans - $45 million for small-business tax cuts, $40 million to mitigate college tuition increases, $25 million for state pensions, $19 million to add a day to the school calendar and $10 million for agricultural development. Legislators like the sound of that money but worry protracted litigation would leave the state with nothing. "The bird in hand is worth two in the bush," Adams said.

Arnold Simpson, the Covington Democrat who is vice chairman of the House Appropriations and Revenue Committee, was even harsher: "I'm not going after fool's gold ... if it puts the state into the chaos of mass litigation."

Ten other states have looked at similar proposals, but none of them passed it.

Greenwold said statements by Fletcher and the proposal's advocates about their intent would jeopardize the state's position in court. Kentucky runs the risk of losing both the MSA payments and having its fee struck down - "the worst of both worlds," he said. Even if the fee survives, litigation could tie up both payments for years, Adams said.

Tobacco companies: The proposed change has split the tobacco manufacturing community. Large companies who were part of the original MSA - Philip Morris Inc., R.J. Reynolds Tobacco Co., Brown & Williamson Tobacco Corp. and Lorillard Tobacco Co. and Liggett & Myers - strongly oppose it, saying it would give smaller, independent firms who have opted out of the deal an unfair price advantage. But the independents - who many see as the driving force behind the proposal - like it and say the bigger firms fear losing market share and control of cigarette distribution.

"(They) are trying every scare tactic in the world because they're afraid of losing control of the MSA," said Bob Rowland, a lobbyist with the Council of Independent Tobacco Manufacturers of America.

In general, the original manufacturers pay up to $4 a carton into the pot, although they get a discount for cartons sold in four states (Florida, Minnesota, Mississippi and Texas) that had previously settled. Some companies who subsequently joined pay even less, since they received exemptions equal to 125 percent of their 1997 sales volume. Meanwhile, non-participating manufacturers pay a $4 per carton fee into an escrow account that will be returned to them in 25 years. But the smaller companies say that's unfair because they have to pay tax on that income, whereas larger companies can deduct their fee payments.

Under the proposal, all companies would pay a $4-a-carton fee to Kentucky and the escrow requirement would die. The non-participating companies say that would create a level playing field because big companies could get a federal offset on MSA fees.

"Absolutely, categorically a vicious lie, and they know it," said state Rep. Rob Wilkey, D-Scottsville, a member of the House A&R committee and general counsel for cigarette maker Commonwealth Brands. Wilkey said the fee would essentially create a double tax.

The MSA: Cave, Rowland and other advocates say the new fee would leave much of the MSA intact, since Kentucky would legally only be eliminating its escrow statute. But opponents such as Greenwold and Philip Morris USA spokesman Bill Phelps say it would be a breach of the overall settlement that could jeopardize the whole thing.

Greenwold said the change would hurt the MSA in several ways. One, it would invalidate the marketing and lobbying restrictions that have helped reduce teen smoking and clean up advertising. Two, by giving smaller tobacco companies an advantage, it would cut into sales by large companies and reduce the MSA pot. Three, it would give incentives to future manufacturers not to sign up.

The beauty of the MSA has been that "the states have hung together," he said.

Almost all agree that the change would lead to litigation, whether from the big tobacco companies or other states, including some who have already accepted future MSA payments through securitization agreements.

But Cave and others say Kentucky could protect itself legally by "dating" the change to take effect next year and seeking a declaratory judgment from the courts in the meantime.

Attorney General Greg Stumbo, in an informal opinion Jan. 26 that warned of the likelihood of protracted litigation, urged legislators to seek such a court ruling, which essentially is a decision without a lawsuit. Deputy Attorney General Pierce Whites said this week the office would likely make that move itself once it sees specific litigation.

Consumer prices: Cave said economists have predicted the new taxing structure would increase the price of a pack of cigarettes by only 5 cents to 15 cents because the tobacco companies would spread the cost over the national market, not just Kentucky. Rowland said the effect would be less than a penny a pack.

But Wilkey called such claims ridiculous, saying he knew of no state-specific tax that was borne by other states. He predicted a pass-through effect of 40 cents a pack.

Raw deal: In his speech, Fletcher complained about the "bad deal" Kentucky got and suggested former Attorney General Ben Chandler erred in getting Kentucky to the table late and accepting a distribution formula that was based on Medicaid costs and population instead of cigarettes sold.

But Chandler, who lost the gubernatorial race against Fletcher in 2004 and is now a Congressman, angrily criticized the governor for putting forward "revisionist" thinking. The formula was appropriate because the tobacco lawsuit was based on health care costs, Chandler said, and Kentucky would have gotten nothing if it had not signed the deal.

Kentucky did not officially sue to join the lawsuit until the last minute because he was told by tobacco-supporting legislators that his office would have its budget stripped if Kentucky got in early, Chandler said, who nonetheless said Kentucky had a seat at the negotiating table long before then.

Furthermore, Kentucky farmers benefited greatly from hundreds of millions in Phase II payments, he said. "It shows how incompetent they are," said Chandler. "They're not familiar with the agreement." And, he noted, the General Assembly unanimously voted to accept the MSA, as did Fletcher, then in Congress.

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